

EXECUTIVE CHAMBERS  
State Capitol  
Honolulu, Hawaii 96813

GOVERNOR'S MESSAGE TO THE 23RD STATE LEGISLATURE OF  
HAWAII MEETING IN THE FIRST REGULAR SESSION 2005

Pursuant to the provisions of Chapter 37 of the Hawaii Revised Statutes, I have the privilege of presenting for your consideration the Executive Budget for Fiscal Biennium 2005-07 and the updated Program and Financial Plan for the period 2005-11.

The recommendations contained herein are the result of hard work and thoughtful consideration by departments and agencies as they strive to meet the public's needs under stringent policy guidelines and fiscal constraints.

**FISCAL POLICY**

Last year, I conveyed to you the overall fiscal policy and agenda that I intended to pursue during my Administration. The principles that I spoke of then have not changed; they continue to serve as guideposts for our budgetary actions. Let me briefly restate the following main objectives:

1. The State must live within its means. The public resources we use must be supported and sustained by the State's economic base and the revenues it

generates. As we will never have enough resources to satisfy all needs and desires, working within revenue constraints requires an ongoing fiscal discipline that will force government to be clear about its priorities.

2. The budget should have structural balance. We need to focus on long-term financial planning to ensure that our recurring expenses are matched with recurring revenues. We may not get to this goal right away but our commitment to this principle will help realign our revenue and expense parameters as needed.
3. We will adhere to responsible budgeting practices to improve fiscal accountability.

In this regard, we strongly recommend that all funding requirements be identified and placed within the budget so that total demands on resources can be properly evaluated. Specific appropriations should be used sparingly and reserved for circumstances that

truly merit such consideration. Emergency appropriations and collective bargaining (CB) authorizations are two such cases.

For the new biennium budget, we are taking significant steps toward eliminating the current practice of paying wages with borrowed money by converting project-funded positions to operating budget positions.

In addition, we should severely limit raiding special funds as a convenient means of balancing the general fund budget.

Finally, I believe that the presentation of budget information should be clear and user friendly. We need to have a budget format that aligns with departmental responsibilities, is more transparent about performance standards, and is easier to read.

4. We will strive to establish fiscal stability and reduce fiscal stress.

To even out budget fluctuations that can be expected and avoid budget shortfalls that can be disruptive to operations, an adequate reserve must be maintained to provide a degree of stability in the State budget. The creation of the Emergency and Budget Reserve Fund was a good start and I remain firm in continuing to protect this fund. The Hurricane Relief Fund is another source of reserves that I intend to safeguard for future emergencies.

In the past two years, these good principles of fiscal management have served us well.

We have successfully overcome the projected revenue shortfalls in FYs 03,04, and 05 by holding down discretionary spending through restrictions and spending moratoria, by adopting workforce control measures, and by requiring departments to trim expenses in targeted areas. During this Administration, the State has begun to live within its means.

This move toward long-term structural balance between expenses and revenues requires a sustained focus on critical, strategic priorities and control over wages and fringe benefit costs.

With this year's submission, I am pleased to present a new format for the Executive Budget. This new format uses all currently available budget information but presents it in a different way to be more relevant and user friendly. Budget information is provided for each department and the data are aligned with departmental functions. Performance measures are also included for the programs operated by each department. To comply with statutory requirements, budget information as specified by Chapter 37, HRS, is still available in other sections of this document.

#### THE ECONOMY

Following a strong performance in 2003, Hawaii's economy experienced another good year in 2004. Key economic indicators show that important gains have been made in employment and personal income. We have:

- Record employment levels. After a decade of declining job counts in the 1990's, the number of wage and salary jobs started to rise steadily in recent years. Currently, it stands at an all-time high of over 580,000 jobs.
- One of the lowest unemployment rates in the nation. At 3.3% in October 2004, Hawaii's unemployment rate is considerably below the 5.5% national average.
- A diversified employment base. Strong job growth has occurred in all areas of the private sector: retail trade, healthcare and social assistance, professional and business services, construction, and accommodations.
- Steady improvements in personal income. Since 2002, Hawaii's growth in personal income has averaged 5% annually, again at a higher level than the national average.

This solid performance was the result of impressive growth in all of our key sectors.

The visitor industry registered one of its best years ever in 2004 with robust increases in both domestic and international arrivals. There were also healthy increases in visitor expenditures and hotel occupancy rates.

The construction industry has enjoyed a tremendous boom in the past several years and the numbers point to

continued growth for residential as well as commercial projects. The real estate market has been exceptionally strong since 2002.

Military expenditures have been substantial and are expected to continue at a high level with the \$2.2 billion approval from Congress for renovation and new construction of military housing over the next 14 years.

In short, Hawaii's economy has fully recovered from the depth of the September 11 aftermath. The strong economic performance in the past two years has been the result of even, steady, and widespread improvements throughout the local economy. This is a good economic foundation to build on. There is general consensus that, barring unforeseen events, moderate economic growth will continue in the next few years. Our optimism remains tempered by a concern over the possibility of inflation and the reality of political instability in the world.

#### REVENUE PROJECTIONS

At its most recent meeting on September 9, 2004, the Council on Revenues projected that general fund revenues to the State will grow by 8.8% in the current FY 05, and by 5.3% to 5.7% in the upcoming FY 2005-07. Revenue growth for the four out-years (2008-2011) was forecast to be in the range of 5.2% to 7.4%. These projections show that future revenues are expected to grow at a more moderate pace, compared to the high performances of 8.3% in FY 04 and 8.8% as projected for FY 05.

As of October 2004, the cumulative growth for general fund tax revenues in the first four months of FY 05 was 11.1%. While this is a welcome sign, we view it with caution because there are still eight remaining months to the fiscal year and we know of the inherent fluctuations from month-to-month.

#### **THE STATE'S GENERAL FUND FINANCIAL PLAN**

FY 04 began with a carry-over balance of \$117.2 million in the General Fund and ended with a \$184.6 million balance on June 30, 2004. This balance was achieved through a combination of a) strict budgetary measures to control payroll and reduce discretionary spending, b) transfer of excess special fund balances as authorized by the Legislature, and c) a higher than anticipated increase in revenues toward the end of the fiscal year.

For the current FY 05, we continue to monitor expenditures with caution and the control over filling vacant positions remains in effect.

For the upcoming FY 2005-07, the Executive Budget general fund requests amount to \$4,405.9 million in FY 06 and \$4,523.4 million in FY 07. This represents an increase of \$444.0 million (11.2%) and \$561.5 million (14.2%), respectively, over general fund allocations for the current FY 05.

These numbers represent significant increases in the cost of government and they will erode much of the positive balance projected for the General Fund at the end of this fiscal year. The increases are primarily related to CB pay raises that have been authorized and

non-discretionary expenses, or the fixed-cost category, such as fringe benefits, debt service, social assistance payments, and court-mandated services. Specific numbers regarding these categories are provided in a subsequent section.

In the days to come, our Administration will submit legislative proposals for your consideration. Among them will be measures that may have a significant financial impact on the State. Taking into account the requests contained in this Executive Budget and the fiscal impact of legislative proposals to be submitted, the ending balance in the General Fund is projected to be \$80.2 million in FY 06 and \$10.7 million in FY 07. The General Fund financial plan also shows a positive number for each year of the six-year financial plan.

The Multi-Year General Fund Financial Plan is presented on page 54 of this document.

The State's prudent approach in managing its budget has been favorably recognized by all three major credit rating agencies. Presently, Hawaii maintains a AA3 rating by Moody's and AA- by both Standard & Poor's and Fitch. Moody's Investor Service has just recently (in October 2004) upgraded the outlook on the State from "stable" to "positive."

#### **THE PROGRAM AGENDA**

In developing the FY 2005-07 Executive Budget to be recommended for your consideration, our objective was to maintain a responsible balance between being fiscally

prudent, taking decisive actions to address current community needs, and investing in the State's future.

The recommendations contained in this budget reflect the decisions and priorities I have established for the next fiscal biennium and the four additional years in the planning period. The critical areas that were set out for highest priority continue to be education, the economy, the environment, healthcare, and public safety. This budget continues to provide steady growth in funding for these key governmental functions. Within this overall framework, I would like to highlight the following initiatives.

#### Education

Last year, the Legislature passed Act 51 that provided additional funding for our schools. For the new biennium budget, \$9.5 million has been included in each year to continue this funding.

Additional funds are also recommended for staffing and operating costs of new facilities, for increases in fringe benefit and debt service requirements, and for certain anticipated shortfalls in current programs.

To continue the special focus on bringing school facilities to acceptable standards, a substantial increase of \$8.6 million each year in general funds has been added to the current \$6.5 million for special repairs and maintenance, and a lump-sum \$100 million each year in bond funds is recommended for capital improvement program (CIP) projects to be determined by the Department of Education (DOE).

Charter schools are a critical component of the State public education program and provide an important alternative for Hawaii families and communities. The new biennium budget includes \$31 million in general funds for each year for an estimated enrollment of 5,369 students.

#### Early Childhood Education

Experiences in a child's early years lay the foundation for school success and lifelong learning. This budget recognizes the critical importance that early education can play in the development and success of children. In particular it recognizes the importance of ensuring that children are ready to learn when they enter the formal school system. To continue the State's commitment to providing quality child care choices for parents, this biennium budget continues substantial funding each year for a consortium of related programs such as Preschool Open Doors, Family Child Care, Hawaii Pre-Plus, Special Education Preschools, and the junior kindergarten program. This funding level will permit over 15,000 children ages 3 and 4 to obtain quality childcare services to prepare them for their formal schooling.

#### Higher Education

The University of Hawaii (UH) and the ten-campus community college system provides opportunities for over 35,000 individuals to pursue associate, bachelor and advanced degrees. It is critical that the State recognize this institution as a key component of our economic well-being and a major part of the social fabric that makes Hawaii a desirable place to live and work. This biennium budget reflects a major new commitment to

the State's university system and includes \$20 million in new scholarship funds to ensure that our record of access for all who want a higher education remains in place. A total of \$25 million is also recommended for support of other priorities of the University. Furthermore, the biennium budget recognizes the need to invest in the infrastructure of the University, providing a commitment of \$100 million to rebuild and replace deteriorated buildings and create campuses that can accommodate students in safe, clean, and well maintained structures.

#### Economic Development

The new biennium budget includes:

- \$500,000 each year for business development programs to market Hawaii products and services.
- Substantial additional funds (\$8.2 million and \$9.7 million in FY 06 and FY 07, respectively) for the Hawaii Tourism Authority to expand tourism promotion programs.
- \$1.5 million each year as State matching funds to support UH in securing a second Experimental Program to Stimulate Competitive Research grant from the National Science Foundation. This grant targets collaborative partnerships between the University and the local business community to facilitate technology transfer and commercialization.

- Planning and design money to support efforts to revitalize the Kakaako development district and the Aloha Tower/water front area.

#### The Environment

To continue the progress made in protecting and preserving Hawaii's environment, I am including a recommendation of \$4 million each year (\$1 million of additional funds) to strengthen our commitment to the control of invasive species. Legislation approved last year established the Hawaii Invasive Species Council to develop and implement a partnership of federal, State, county, and private entities for a comprehensive statewide prevention and control program. The plan concentrates on four major areas: prevention, response and control, research and applied technology, and public outreach. The additional money in the new biennium will allow these important efforts to go forward.

While funding of the invasive species control program is under the Department of Land and Natural Resources, collaborative activities are also maintained with the Department of Agriculture (DOA). Additional positions and funds are recommended for the DOA to step up its efforts in identifying and controlling the brown tree snake, the coqui frog, and other alien species. Toward this goal, we will ensure that 100% of flights from Guam will be inspected. Funds will also be transferred to the Department of Health to improve surveillance and rapid response capabilities to address the threat of West Nile Virus importation.

Our goal to improve the natural and recreational environment will be supported by a commitment of \$10 million in bond funds each year for State parks and equal amounts for the small boat harbors.

The biennium CIP program also includes \$2.1 million to maintain and improve irrigation systems on Molokai and Hawaii (Waimea area) to protect water sources for farmers.

#### Healthcare

To meet continuing needs in the area of adult mental health, additional funds and positions are requested for community health centers and purchases of mental health services. Additional general funds are also included in both years for the developmental disabilities program, for primary care services for the uninsured, and for comprehensive medical services at Molokai General Hospital, Kahuku Hospital, and Hana Community Health Center.

\$4.8 million and \$6.8 million in bond funds are recommended for CIP projects at the State Hospital and at Hawaii Health Systems Corporation facilities, respectively.

#### Public Safety

The State's correctional system continues to face three major problems: inmate overcrowding, aging facilities, and a high demand for treatment services. Funding is requested in the new biennium budget to plan for a new community correctional facility in West Hawaii. As an

alternative to wholly owned State facilities, other approaches may also be explored, such as a public/private partnership for the construction, financing, and operation of this center.

To alleviate overcrowding, additional funds are included to send an additional 526 inmates in FY 06 and 701 inmates in FY 07 to out-of-state facilities (\$10.2 million and \$16.7 million, respectively), and to house an additional 140 in the Federal Detention Center in Honolulu (\$4.4 million and \$4.6 million, respectively). By FY 07, there will be over 2,500 contracted beds to accommodate the expanding inmate population. We will also ask for flexibility to allow these funds to be used to provide treatment services for inmates who can benefit from such programs.

Closely related to the problems of inmates and prisons is the explosion of illegal drug use, most notably the ice epidemic. The Administration Drug Summit, led by Lieutenant Governor Duke Aiona, pointed to the need for an integrated approach to combating this problem, one that recognizes that individuals, families, and communities must be equal partners with State and county governments in this endeavor. The Legislature also recognized the ice crisis in Act 40, SLH 2004, and appropriated additional funding to combat this problem. My recommendation for the new biennium is to sustain the current funding level of \$19.8 million as authorized under Act 41, SLH 2004. We need to have a clear assessment of the results of these funds before committing to a higher level of expenses. Therefore, I have not included in my recommendation for the new biennium all of the additional funds appropriated under

Act 40, SLH 2004. I do, however, recommend adding \$2 million each year for community-based substance abuse prevention programs and over \$1 million each year for adolescent residential treatment and school-based counseling/treatment programs.

The Drug Nuisance Abatement Unit in the Department of the Attorney General has proven to be effective in targeting drug dealers and their activities in residential neighborhoods. Additional funding and positions for this program have been included in the new biennium budget to further these efforts.

Besides the high priority programs discussed above, other important issues have also demanded special attention in the new biennium budget.

#### Affordable Housing

Affordable housing presents a real challenge as the price of residential real estate continues to break previous records. The Rental Housing Trust Fund is a critical component in the ongoing efforts of the Housing and Community Development Corporation of Hawaii (HCDCH) to meet the affordable rental housing needs of the people of Hawaii. I am recommending an infusion of \$2 million each year to enable the program to produce additional rental units. Together with other available financing sources, including legislative proposals to be submitted, up to 450 new rental units will be produced annually. \$10 million each year in bond funds is also provided to the HCDCH for renovation of public housing.

On another front, faster development of affordable housing is being pursued by the Department of Hawaiian Home Lands (DHHL) for its beneficiaries. A total of 1,848 acres of State lands have been or will be conveyed to DHHL for this purpose. In the new biennium budget, \$10 million each year in bond funds has been set aside to supplement existing DHHL resources to produce approximately 700 additional units annually for Native Hawaiians.

#### Homeless Programs

Significant increases in funding are proposed for programs serving the homeless population. Additional funds will allow the stipend program to increase capacity at shelters and cover an additional 1,260 persons. Expansion in outreach services will help 5,200 more people. And the grant program, which assists with basic living expenses, will be expanded statewide to help an additional 300 families in need.

#### Transportation

The biennium budget proposes a number of capital improvement projects to address critical transportation needs on all islands. These include:

- Saddle Road, Hawaii - Funds are requested to begin construction of major improvements to provide a safe and efficient route between East and West Hawaii. When fully improved, this corridor will become the major transportation link connecting the two sides of the Big Island.



- North-South Road, Oahu - Construction of a new multi-lane arterial from Kapolei Parkway to H-1 is needed to accommodate future growth and development in the "Second City" area of Ewa and Kapolei. As a major north-south corridor for this area, this highway will also provide access to the proposed UH West Oahu campus.
- Honoapiilani Highway, Maui - Continuation of widening improvements, from two to four lanes from Lahainaluna Road to Aholo Road, will relieve traffic congestion through Lahaina town.
- Kaunualii Highway, Kauai - Continued widening will provide two additional lanes for through traffic between Lihue and west of Maluhia Road, improving commuting time and safety.
- Hilo Harbor, Hawaii - Construction of improvements to the barge terminal will result in a high capacity pier, yard, and shed to accommodate modern barges and cargo handling equipment.
- The Super Ferry - Design and construction for statewide ferry terminal improvements are proposed to develop the Super Ferry system, providing inter-island passenger, vehicle and cargo transportation alternatives for Hawaii residents and visitors.

## THE EXECUTIVE BUDGET RECOMMENDATIONS

### THE OPERATING BUDGET

#### All Funds

Total OPERATING BUDGET requests from all funding sources amount to \$8,852.6 million in FY 06 and \$9,057.7 million in FY 07. This represents an increase of \$848 million (10.6%) and \$1,053 million (13.2%), respectively, over current FY 05 allocation levels.

<u>Means of Financing</u>	<u>FY 05 Allocation</u>	<u>FY 06 Request</u> (\$million)	<u>FY 07 Request</u>
General Fund	3,961.9	4,405.9	4,523.4
Special Funds	1,610.2	1,679.3	1,688.3
Federal Funds	1,421.6	1,483.3	1,515.4
Private Contributions	0.1	0.1	0.1
County Funds	0.2	0.2	0.2
Trust Funds	40.1	38.6	42.4
Interdept. Transfer	636.4	871.2	929.4
Revolving Funds	315.3	365.3	349.7
Other Funds	<u>18.9</u>	<u>8.8</u>	<u>8.8</u>
Total:	8,004.7	8,852.6	9,057.7

The distribution by department is presented on page 76.

### General Fund

For the new fiscal biennium, total OPERATING BUDGET requests from the General Fund amount to \$4,405.9 million in FY 06 and \$4,523.4 million in FY 07. This represents an increase of \$444 million (11.2%) and \$561 million (14.2%), respectively, over current FY 05 allocation levels. The distribution by department is presented on page 78.

While our goal is to hold down the cost of government, most of the increases are directly related to non-discretionary expenses. These include:

	<u>FY 06</u>	<u>FY 07</u>
Increases from FY 05:	(\$ million)	
Debt service	164.6	228.6
Annualized CB pay increases	61.7	73.2
Fringe benefits	74.3	107.8
Social assistance entitlements	30.8	44.8
Federal/court mandates	<u>13.9</u>	<u>15.4</u>
Sub-Total, Non-discretionary Increases	345.3	469.8
Percentage of Total Increases	78%	84%

At \$513 million in FY 06 and \$577 million in FY 07, debt service cost shows a significant increase (47% and 66%, respectively) over the \$348 million in FY 05. This is primarily due to refunding and restructuring activities in prior years (since FY 02) to take advantage of low interest rates, resulting in debt relief in FYs 04 and 05. However, debt service will rise in FY 06 and beyond.

Pay raises from collective bargaining were authorized for half of FY 05 for most units. Increases in the new biennium budget reflect the full year costs.

Fringe benefit costs include the employer contribution for pension accumulation, for Social Security and Medicare, and for health insurance premiums. The rising costs are due to a higher salary base and projected enrollment growth.

Payments for welfare entitlement programs continue their steady climb, from about \$520 million in FY 05 to \$550 million and \$564 million in the new biennium. The increases occur primarily in the Medicaid, foster care, and State supplement of the Supplemental Security Income programs. We will need to take actions to limit the growth of these programs in the years ahead.

Finally, the State must still comply with court-ordered requirements relating to the Hawaii State Hospital, the Adult Mental Health program, the Makin lawsuit over developmental disability services, and the Felix consent decree.

### Increase in Position Count

The biennium budget requests include a significant change in the number of positions, as compared to current FY 05 allocation levels.

	<u>FY 06</u> <u>Request</u>		<u>FY 07</u> <u>Request</u>	
	<u>Temporary</u>	<u>Permanent</u>	<u>Temporary</u>	<u>Permanent</u>
Total Add'l Positions	68.42	524.25	71.42	577.75
By means of financing:				
General Fund	-0.33	-109.05	-2.58	-61.55
Special Funds	12.50	433.00	15.60	433.00
Federal Funds	24.63	125.30	26.90	125.30
Trust Funds	3.00	3.00	3.00	3.00
Revolving Funds	9.63	59.00	9.50	65.00
Interdept. Transfer	20.00	12.00	20.00	12.00
Other Funds	-1.00	1.00	-1.00	1.00

Several factors contribute to these numbers.

- The largest change occurs in the special fund category and results from the conversion of project-funded positions to operating budget positions, mainly in the Department of Transportation (408 positions).
- The additional numbers also reflect the incorporation into the biennium budget of positions restored by Act 154, SLH 2004, and those authorized in various specific appropriation measures.
- Other additions represent requests for court mandated or high priority programs.
- The net reduction under the general fund category reflects a decrease of 251 DOE positions due to declining enrollment (-88 positions in regular education and -163 in special education).

#### THE CAPITAL IMPROVEMENT BUDGET

Total CIP BUDGET requests from all funding sources amount to \$804 million in FY 06 and \$719 million in FY 07.

	<u>FY 06</u> <u>Request</u>	<u>FY 07</u> <u>Request</u>
	<u>(\$million)</u>	
Means of Financing		
Special Funds	87.7	85.2
G.O. Bonds	333.0	264.0
G.O. Bonds Reimbursable	10.0	10.0
Revenue Bonds	49.7	106.0
Federal Funds	228.9	234.1
Private Funds	14.0	.....
Revolving Funds	32.0	20.0
Other Funds	47.8	.....
County Funds	<u>0.4</u>	<u>.....</u>
Total:	803.5	719.4

The distribution by department is presented on page 82.

The CIP requests represent the necessary improvements the State will need to make to its capital assets and infrastructure to support its economic base as well as maintain the health, safety, and quality of life in Hawaii.

Highlights of the FB 2005-07 CIP program by department are presented in the sections that follow (page 89).

#### THE GENERAL FUND EXPENDITURE CEILING

By law, general fund appropriations must comply with the expenditure ceiling requirements that are set forth in Section 9, Article VII of the Hawaii State Constitution and Section 37-92 of the Hawaii Revised Statutes.

At the aggregate level, including all branches of government, total proposed appropriations from the General Fund are within the expenditure ceilings for both FY 06 and FY 07.

For the Executive Branch, total proposed appropriations from the General Fund (which include the Executive Budget for FY 2005-07 and other specific appropriation measures to be submitted) are within the appropriation ceiling for FY 07 but will exceed the appropriation ceiling in FY 06 by \$108 million (or 2.5%). The reasons for this excess are due to the substantial requirements in pay raises and non-discretionary costs such as fringe benefits, debt service, social assistance payments, and mandated programs.

A summary statement on the General Fund expenditure ceiling and Executive Branch appropriation ceiling is presented on page 55 of this document.

#### THE DEBT LIMIT

Section 13, Article VII of the Hawaii State Constitution places a debt limit on G.O. bonds that may be issued by the State. It has been determined that the total amount of principal and interest calculated on a) all bonds issued and outstanding, b) all bonds authorized and

unissued, and c) all bonds proposed in the Executive Budget, including State guaranties, will not cause the debt limit to be exceeded at the time of each bond issuance.

The Declaration of Findings with respect to the G.O. bond debt limit is presented on pages 65 through 71 of this document.

In summary, I respectfully ask for your favorable consideration of the recommendations presented herein and look forward to working with you in the upcoming session to bring forth a Biennium Budget that is fiscally prudent and responsive to the substantial needs of our community.

Sincerely,

/s/

LINDA LINGLE  
Governor of Hawaii